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BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF GOLD CANYON SEWER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES FOR UTILITY SERVICE BASED THEREON.	DOCKET NO: SW-02519A-06-0015

GOLD CANYON SEWER COMPANY'S

REPLY BRIEF

Arizona Corporation Commission
DOCKETED

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ARIZONA CORPORATION COMMISSION
PRE-FILED TESTIMONY

Pre-Filed Testimony	Hearing Exhibit	Abbreviation
Direct Testimony of Trevor Hill	ACC-2	Hill PT

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INTRODUCTION

By all accounts, the two most problematic issues in this rate case were customer complaints about odors and comments made to customers by former GCSC employee Trevor Hill. Now, following closing briefs, there is no dispute between the parties over odors, and only a minor dispute with Staff over a remedy for Mr. Hill's comments remains. Cost of capital is still in dispute. RUCO and GCSC remain at odds over several issues including RUCO's excess capacity adjustment and its proposed adjustments for property tax and rate case expense. Based on the closing briefs, the most contentious issue that remains is affiliate profit—an issue over which the Company believed there was no significant dispute given the Commission's recent decision in the BMSC rate case. *See* Company BR at 12-16.[1]

In its Closing Brief, Staff goes on the attack, spending roughly two-thirds of its 36-page brief seeking to portray the Company, its shareholder and affiliates (and apparently Global Water Resources too) as some sort of modern-day utility robber barons preying on Arizona's captive ratepayers. Staff misstates both the law and underlying evidence on the affiliate profit issues. The underlying record does not contain any evidence indicating that GCSC's affiliate transactions resulted in excessive profit or costs to customers. Unfortunately, Staff's arguments on affiliate profit demonstrate a fundamental lack of knowledge regarding operating and running a sewer utility in today's market. It also appears that Staff has forgotten that the "affiliate profit" at issue involves less than $100,000 of annual revenue, roughly 2% of the revenue at issue in a case both parties agree is driven primarily by more than $12 million of new rate base. Should it

[1] Citations to the record are made using the same format, abbreviations and conventions as in GCSC's Closing Brief, abbreviated "Company BR" herein. Staff's Closing Brief is abbreviated as "Staff BR" and RUCO's Closing Brief is abbreviated as "RUCO BR". A list of the witnesses' pre-filed testimony is again provided after the Table of Contents for the Assistant Chief Administrative Law Judge's convenience.

choose to adopt Staff's adjustment to exclude affiliate profit from GCSC's rate base, the Commission instantly eliminates any perceived harm resulting from profit earned by affiliates on services provided to GCSC. *See, e.g.*, TR at 406 (Sorensen).

But, Staff's closing brief goes far beyond a simple adjustment to eliminate so-called "affiliate profit." Staff makes a litany of policy arguments and factual claims aimed at establishing a Commission policy of disallowing affiliate profit under any and all circumstances. Staff also suggests that Algonquin's utility business model is illegal or imprudent. On both accounts, Staff misstates the facts, misapplies governing law and advocates bad public policy. In turn, the Company is compelled to respond to Staff's attack on its reputation, and that of its shareholder and affiliates, and to address Staff's unlawful and ill-advised position on affiliate profit, including its request that the Commission regulate AWRA.

ANALYSIS AND ARGUMENT

A. Affiliate Transactions

Undoubtedly, Staff is alarmed over the affiliate-services business-model being employed by Algonquin and Global Water Resources in Arizona. *See* Staff BR at 3. Staff goes to great lengths to characterize this business model as unique and distinct from any other Arizona utility. In reality, holding company business models are not unusual. Nevertheless, Staff feels that Algonquin's organizational model and affiliate transactions "present significant difficulties for the Commission's regulations of utilities." Staff BR at 3. On that issue, however, Staff does not specifically identify these "significant difficulties." In truth, the affiliate profit issue in this rate case isn't difficult to understand or resolve at all. Staff asked the Company to disclose how much profit[2] was included in rate base and operating expenses arising from affiliate transactions. The Company disclosed the amount of profit. Staff recommends excising it from the revenue requirement, and, if the Commission agrees, there will be no harm to ratepayers. Staff's witness testified that her recommended rate base and operating expenses were all reasonable. TR at 1174-75 (Brown).

But Staff is not satisfied with a mere adjustment to remove affiliate profit in this case. Staff also wants to convince the Commission that (1) all of the Company's operating expenses are suspect because of the business model employed; (2) the Commission should issue a sweeping precedent regulating affiliate transactions and banning all profits between affiliates; (3) the Company, and its affiliates and shareholders, must be subjected to Commission orders directing specific operations requirements; and (4) the Commission should mandate a holding company business model for Arizona utilities that requires such entities to employ affiliate transactions to lower service costs but does not allow such affiliates to earn a profit on such services. Staff's suggestions and arguments on these issues violate due process and governing law. Moreover, this docket is not a rulemaking, it is a rate case. The Commission simply does

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[2] In this case, the term "profit" really means the markup added to the cost of services provided by GCSC's affiliates relating to billing, managing and operating the utility. On that note, it should be mentioned that before Algonquin acquired the stock of GCSC in 2001, GCSC's prior owner (Shea Homes) employed Faciligroup (an affiliate of Diamond Engineering) as an independent contractor to provide billing, management and administrative services for utility operations. TR at 707 (Hill). Naturally, as a for-profit company, Faciligroup charged GCSC its cost for such services plus a markup. As such, GCSC customers do not suffer any harm or increased expenses resulting from GCSC's affiliate transactions plus markup. To the contrary, the economies of scale gained by GCSC in using affiliates for such services results in a lower average cost to customers for such services. Bourassa RB (Ex. A-11). By excluding affiliate profit in this case (and the BMSC case), Staff gives customers a windfall based solely on the dangers of affiliate transactions without any showing that GCSC's (or BMSC's) affiliate transactions have resulted in unreasonable costs or excessive profits.

not have the legal authority to legislate "shared services" in the manner suggested by Staff.

The Company is cognizant of the Commission's concerns over the business model being employed to operate GCSC. But this model is innovative and does not pose any significant regulatory difficulties. The BMSC rate case decided two months ago was the first time the Commission considered this business model in any significant fashion. Staff BR at 9. It is premature to condemn a business model that results in substantial economies of scale and enhanced services. Incredibly though, Staff condemns the Algonquin/Global business model without any analysis of economies of scale, enhanced services or benefits to customers. All of Staff's arguments are abstract policy-related concerns, the kind of concerns that can be readily addressed in a rulemaking proceeding. Staff did not make any evidentiary findings regarding the disadvantages of this business model as applied by Algonquin or any negative impacts on customers. To the contrary, the evidence appears *undisputed* that GCSC's service quality has improved substantially under Algonquin's ownership. *See* Ex. A-23; RUCO Response to Testimony of Trevor Hill at 4.

Again, if the Commission is concerned about the entire industry, or the policy implications of affiliate transactions, then the Commission must conduct a rulemaking where all interested parties can be afforded due process and the Commission can explore every aspect of the issue. Electric utilities have codes of conduct for affiliate transactions, and the Commission has holding company rules. This situation is no different, except that Staff wants to use this rate case to create *de facto* rules governing the operations of regulated utilities and their unregulated shareholders and affiliates. Any such action by the Commission in this docket would violate fundamental principles of fairness and due process.

1. There Is No Nationwide Prohibition Against Affiliate Profit

Staff asserts that affiliate profits "are not permitted under ROE regulation." *E.g.*, Staff BR at 23 (no supporting authority offered). Staff likewise asserts that there is a nationwide, industry standard for the use of shared services by regulated utilities:

> In the utility industry in the United States, holding companies for regulated utilities typically create shared service centers to take advantage of economies of scale. Economies of scale allow utility services to be provided at a lower cost. Shared service centers provide only a portion of the services necessary for the provision of utility service. Subsidiary utilities provide the remaining portion directly through their own employees. Holding companies then allocate costs to each of their subsidiary utilities on a pro-rata basis. In regulated industries, holding companies provide shared services at cost.

Staff BR at 4 *citing* Brown SB (Ex. S-19) and Ex. S-28 (Staff response to GCSC data request). Staff's claim of a nationwide, industry standard for shared services is supported only by the testimony of its accounting witness, Crystal Brown. However, Ms. Brown does not have the experience, knowledge, expertise or qualifications to testify to a nationwide, industry standard for shared services. Furthermore, she has no experience with utilities and shared services in jurisdictions outside Arizona. *See* Brown DT (Ex. S-18) at 1. In fact, there are jurisdictions that allow affiliate profits when they are shown to be reasonable.

In *GTE Florida Inc. v. Deason,* 642 So.2d 545 (Fla. 1994), the Florida Supreme Court overruled a decision of the Florida Public Service Commission to adjust certain costs of affiliate transactions with affiliates, GTE Services and GTE Data. The Court held:

> That the PSC abused its discretion in its decision to reduce in whole or in part certain costs arising from transactions between GTE and its affiliates, GTE Data Services and GTE Supply. The evidence indicates that GTE's costs were no

> greater than they would have been had GTE purchased services and supplies elsewhere. <u>The mere fact that a utility is doing business with an affiliate does not mean that unfair or excess profits are being generated, without more.</u> Charles F. Phillips, Jr., *The Regulation of Public Utilities* 254-55 (1988). We believe the standard must be whether the transactions exceed the going market rate or are otherwise inherently unfair. *See id.* If the answer is "no," then the PSC may not reject the utility's position. The PSC obviously applied a different standard, and we thus must reverse the PSC's determination of this question.

Id. at 547-48. The Florida Supreme Court went further and authorized a surcharge allowing the utility to retroactively recover erroneously disallowed charges, including affiliate profit. *See GTE Florida Inc. v. Clark,* 668 S.2d. 971 (Fla. 1996).

In *Washington Water Power vs. Idaho Public Utilities Commission*, 617 P.2d 1242 (Idaho 1980), the court heard an appeal by the utility arising, in large part, due to the PUC's adjustment to expenses paid by the utility to its wholly-owned subsidiary. In that case, the Idaho Supreme Court adopted the "majority" or "traditional approach" to determine the reasonableness of affiliate transactions. The "majority" approach allows recovery of affiliate profit under the right circumstances and views:

> The affiliate as an independent entity and compares the prices and levels of profit on the affiliated transactions with the profits and prices of comparable enterprises. While some cases seem to hold that the fact that the price charged the utility is the same as that charged to independent entities establishes that the price is reasonable (citations omitted), other cases hold that the controlling factor is whether the subsidiary's profits are fair for it, regardless of equivalent prices.
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> * * *
>
> To those courts which hold that profits are controlling, . . . the assumption appears to be that a reasonable price is one that the competitive market would charge.

Id. at 1248-49 (citations omitted).

Staff's claim of a nationwide prohibition on affiliate profit is pure invention. Actually, the so-called no-profit-to-affiliates rules originated with FERC, and FERC "does not magisterially apply the rule as an absolute bar to recovery. In fact, the no-profits-to-affiliates rule has long been construed as a factual balancing test, rather than a bright-line legal test." 10 *Energy Law Journal* 315, *The "No-Profits-To-Affiliates" Rules: A Misnomer*, J. Stevenson (1989) at 2. Thus, the "so-called 'no-profits-to-affiliates' rule is more descriptively labeled the 'no-automatic-acceptance-of-prices-paid-to-affiliates rule.' In other words, the rule as applied is not a substantive prohibition but a heightened level of scrutiny for utilities' transactions with affiliates as opposed to non-affiliates. The rule simply makes heavier the burden of proof that utilities must meet in order to justify their rate change filings." *Id.* at 1.

Staff does not cite a single case or other impartial authority supporting a nationwide, industry standard under which affiliates profits are strictly forbidden. *See* Staff BR at 9-10, 18-19. For instance, Staff relies on *Turpen v. Oklahoma Corporation Commission*, 769 P. 2d 1309 (Okla. 1989), as does the Company. In that case, the court recognized that the utility bears the initial burden of demonstrating that its operating expenses, including any costs of affiliate transactions, are reasonable, but held that "common ownership is not of itself a ground for disregarding agreements with affiliates." *Id.* at 1321. Staff also relies on *General Telephone Company Of Upstate New York, Inc., v. the Public Service Commission of the State of New York, 17 N.Y.2d* 373 (N.Y. 1966). That court also recognized the need for heightened scrutiny when assessing the reasonableness of affiliate transactions with a regulated utility. Staff BR at 9-10 *citing General Telephone* at 378. The court in that case excluded profit from the utility's recovery, but it did not adopt some sort of rule prohibiting affiliate profit in every case, as Staff advocates the Commission should do in this case. Even *Washington Utilities & Trans. Comm'n v. Washington Water Power Co.*, 24 P.U.R. 4th 427 (Wash. U.T.C. 1978), which rejects inclusion of affiliate profits in rates, does not claim there is a nationwide prohibition against affiliate profit under ROE regulation.

It follows that Staff's criticism of the Company's shareholder for failing to "investigate appropriate organizational models for regulated utilities prior to its entrance into the industry" is entirely without merit. Staff BR at 14. Where was AWRA going to investigate how its business model would be treated before it entered the industry? Staff and the Company were unable to find a single decision where a business model like Algonquin's was at issue before the BMSC rate case. *Id.* at 9. The available jurisprudence establishes that there is no industry standard or nationwide prohibition against either the Algonquin business model or affiliate profit. To the contrary, "the ultimate consideration in applying the no-profits-to-affiliates rule is cost justification. Case law suggests that when a price is the result of an arm's length transaction, it is presumptively cost-justified." 10 *Energy Law Journal* 315, *The "No-Profits-To-Affiliates" Rules: A Misnomer*, J. Stevenson (1989), at 4. The only conclusion Algonquin would have come to before investing was that Arizona has no rule prohibiting affiliate profit and that all affiliate transactions would be subject to searching Commission scrutiny with the utility bearing the initial burden to show that its costs of service were reasonable. This is, in other words, an understanding of the process that would have been consistent with Staff's oft-cited mantra that cases should be decided on a case-by-case basis. *See Arizona Water Company-Western Group*, Docket No. W-01445A-04-0650, Hearing Transcript Vol. VI at 1249 (Senior Staff member testifying that that the "Commission has no policies except to explore every issue case by case.").

As for the level of scrutiny to be employed, Staff's claim that "the Company urges the Commission to apply the same standard to affiliates as it applies to non-affiliates" is likewise without merit. Staff BR at 10. In fact, Staff knows its claim is not true. Four pages later Staff states that "the Company admits that affiliate transactions require greater scrutiny." *Id.* at 14. Nor is the Company seeking to evade ROE regulation. *Id.* at 7. The Company is simply asking that the Commission afford fundamental due process, an opportunity to show that a prudent level of operating expenses to provide safe and reliable sewer utility service to its customers includes a reasonable profit on affiliated transactions. Staff actually seems to agree. Staff BR at 15 ("the issue is whether the costs are just and reasonable and fair to captive ratepayers").

2. The Commission Should Refrain From Imposing A Prohibition On Affiliate Transactions Or Affiliate Profit

As mentioned, this case is not the proper forum for rules regarding affiliate transactions or affiliate profit. Moreover, when faced with the issue, rather than adopt a concrete prohibition against affiliate profits as suggested by Staff, the Commission should allow affiliate costs and profits to be included in rate base under the appropriate circumstances:

> The so-called "no-profits-to-affiliates" rule employed by the FERC is in fact a two-tiered market test based on factual circumstances to determine whether or not to allow prices paid to affiliates to be included in the rate base (or, sometimes, passed through dollar-for-dollar as costs)....In exercising its scrutiny, the FERC will look to operational control as the principal determinant of whether to allow payments to an affiliate to be included in the rate case. A useful definition of operational control is "a relationship which by its very nature and history precludes unhampered bargaining ... sufficient to dominate the execution of the contracts in the face of united opposition." In other words, operational control is control of the contract negotiation, and thus the pricing process. In determining whether such control exists, the FERC will consider whether the transaction in question was conducted at arm's length, in the atmosphere of a competitive market. According to applicable case law, competitive, sealed bidding is the best evidence of an arm's length transaction. A showing of competitive sealed bidding establishes that the control of an unregulated supplier by a regulated parent utility is innocuous to ratepayers, and therefore justifies the utility's recovery in rates of its payments to the affiliate supplier.

10 *Energy Law Journal* 315, *The "No-Profits-To-Affiliates" Rules: A Misnomer*, J. Stevenson (1989), at 6. The policy justification for allowing affiliate transactions, costs and profits to be included in rate base under the right circumstances is simple:

> Contrary to earlier belief, fierce competition in atomized markets of the sort contemplated by classical price theory does not always, or even usually, yield the lowest price to consumers; more often, the economies of scale flowing from large, integrated corporations produce lower costs; hence lower prices.

Id. at 7. As discussed above, in its closing brief, Staff ignores the state of the law pertaining to affiliate profits. Staff also disregards the practical and policy justifications for allowing recovery of affiliate costs and profits in the proper circumstances.

In today's world, the stark reality is that the traditional approach to regulating utilities is under increasing market pressures from changing economic forces. In today's market, utilities like GCSC have little choice but to take advantage of economies of scale offered by affiliate transactions to keep costs down. If the Commission excludes affiliate profits from rate base, then such ruling or policy would impose costs on consumers in the form of lost economies of vertical integration and forgone economies of scale. Those lost economies translate into higher costs and higher prices.

Essentially, GCSC has four options for providing billing, operations, management and administrative services. First, GCSC can perform such services itself. That option would require GCSC to hire full-time employees to perform such services and GCSC will not be able to lower costs through vertical integration. Second, GCSC can hire an independent contractor (such as Faciligroup) to perform such services. In that scenario, the independent contractor's costs will include a profit margin or markup which Staff acknowledges would be included in cost recovery. GCSC again would not be able to lower costs through vertical integration. Third, GCSC can take advantage of vertical integration by using affiliates for such services. If the affiliate includes a profit margin in its costs of service, the only difference between this option and option no. 2 (independent contractor) is the perceived conflict of interest resulting from the affiliate relationship.

As noted, however, heightened scrutiny would resolve any perceived conflict of interest.[3] For instance, if use of competitive bidding establishes the market price for the affiliate's costs and illustrates the lack of excessive self-dealing by the utility, then including affiliate profit in rates is no different than including non-affiliate profit in rates in a rate case.

The fourth option is the option suggested by Staff—forcing the utility, its affiliates and its owners, to engage in affiliate transactions (to lower costs) but precluding affiliate profit. Of course, the main problem with this option is that the affiliates will not have any incentive to keep providing such services "at cost." Unregulated affiliates clearly are not in the business of subsidizing utility customers. If the Commission adopts this policy and precludes affiliate profit as suggested by Staff, then utilities like GCSC will not have any leverage to lower costs through vertical integration. GCSC does not exercise any control over AWRA or other affiliates. Also, the Commission does not have any jurisdiction or control over AWRA or other affiliates. If the Commission precludes those affiliates from seeking a profit on such services, then those affiliates will quit providing those services. Sorenson RJ (Ex. A-9) at 8-9. In turn, GCSC will be left with only two options for providing those necessary utility and administrative services—an independent contractor or performing such services itself. Under either scenario, costs of service will increase and so will customer rates.

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[3] In order to remove the specter of affiliate bias, the Commission might adopt a rule requiring competitive bidding, a key element of which is the perceived and actual objectivity of the bid evaluation process. The system must be perceived and applied objectively in order to attract bidders. For example, use of independent third parties to evaluate bids is one technique for achieving such objectivity. Amazingly, Staff's witness discounted the merits of such bidding. TR at 1155-57 (Brown).

Ultimately, the root of the affiliate profit issue is that agreements between a utility and an affiliate are likely not made at arm's length or on the open market. They are between corporations, one of which may control the other. Such transactions are subject to suspicion and possible abuse. However, rather than preclude such transactions altogether, the Commission should focus on ways in which the utility can establish the reasonableness of such transactions, even including affiliate profits.[4]

> One such solution would be mandatory competitive bidding on any transaction in which an unregulated affiliate seeks to engage. This requirement would encourage genuine market efficiency in utility management. Moreover, by effectively taking the control of inter-affiliate transactions out of the hands of the utility holding company and leaving it to the free market, the requirement would firmly proscribe any utility from unduly skewing major investment and expenditure decisions to the advantage of its shareholders.

Id. at 7. The Commission should not foreclose GCSC or any other utility from undertaking such solutions to meet the needs of customers at reasonable rates.

3. The Company's Rate Base And Operating Expenses, With Or Without Affiliate Profit, Are Reasonable

Before reading Staff's brief, the Company had no reason to believe Staff challenged any component of rate base or any operating expense beyond the inclusion of affiliate profit in rate base and operating expenses.[5] Summing up Staff's position,

[4] For example, assume that the cost for billing services provided by an affiliate is \$10/customer, plus a 25% mark-up for a total charge of \$12.50/customer. Further, assume that if the utility were to provide billing services itself, it would cost \$14/customer. Finally, assume that an independent contractor would charge \$11/customer plus 25% mark-up for a total cost of \$13.75 per customer. It makes little sense to prevent the affiliate profit if the net result would be lower than the other options available to the utility. The Commission should broaden, not restrict, a utility's options for using economies of scale.

[5] There are a few adjustments to capitalize expenses items at issue, but the amounts at issue are not significant or related to this discussion. *See* Staff BR at 25.

Ms. Brown testified as follows:

> Q. Miss Brown, did Staff include any plant in any rate base that Staff deems to not be used and useful in this case?
>
> A. No.
>
> Q. Did Staff include any amount in operating expenses – again, it's Staff's recommended expenses – that it does not believe are reasonable given the benefit to customers?
>
> A. No.
>
> Q. Staff believes then that its recommended level of operating expenses is a reasonable level of expenses.
>
> A. Yes.

TR at 1174-75 (Brown). Now, Staff claims that it has serious concerns about affiliate costs and that the facts of this case are "extreme". Staff BR at 11, 19. *See also id.* at 17 (Company could have done more to support the reasonableness of affiliate costs).[6] Staff not only contradicts Ms. Brown's testimony that all expenses other than profit are reasonable, Staff also exaggerates the nature of the facts of this case and, in some cases, simply has them wrong.

For example, it is false that the Company has deprived ratepayers of $115,802 annually by not operating a "shared services center," as Staff alleges. Staff BR at 15. GCSC's shareholder operates a "shared services center" for its regulated subsidiaries—the Algonquin business model is nothing but shared services. The Company and the other utility affiliates have no employees of their own—all services and service providers come from the shared service centers known as AWS, APT and APS. Sorensen RJ (Ex. A-9) at 2-4. GCSC's ratepayers have received the benefit of these shared services and, if

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[6] This assertion is at odds with Ms. Brown's testimony that there was really nothing, including an RFP, that the Company could do to show that affiliate profit was reasonable. TR at 1153-59 (Brown). Ms. Brown's testimony likewise renders suspect Staff's request that the Company be ordered to conduct an RFP. Staff BR at 18.

Staff's adjustment is adopted, customers will also save the entire $115,802 Staff claims should have been saved. TR at 406 (Sorensen).

Expressing agreement with Judge Nodes, Staff also casts doubt on the Company's charges for various telecom related expenses. Staff BR at 15-16. Judge Nodes fairly raised concerns over these charges, but such comments are not evidence. Furthermore, the Company adequately responded. Mr. Sorensen explained why each charge arose in connection with a necessary service, and that AWS continued to explore the possibility and advantages of bundling some communications services. TR at 1209-1215 (Sorensen). No evidence was presented to contradict this testimony. Regarding Staff's claim that profit was added to telecom charges, Staff is mistaken. Telecom services are considered materials and no profit is charged in addition to materials. Ex. S-9.[7] Nor was there any evidence of unreasonableness presented.

Staff also erroneously asserts there is something wrong with the postage pass-through by affiliates to the Company. Staff BR at 8-9. This is inaccurate because Staff has misunderstood the fundamental difference between revenues and expenses. AWS included the cost (to AWS) of postage in its budget. *See* Ex. S-9. The cost of the postage is associated with the Customer Service/Accounting fee (AWS Revenue) charged by AWS to the Company ($3/invoice). *Id.* When AWS prepares a budget, it must account for both revenue and expenses incurred in obtaining that revenue. The Company does not receive a separate charge for postage from AWS, which is why it is not in the Operating Agreement between AWS and Company. *See* Ex. S-4. Postage is simply a cost of doing business borne by AWS, taken into consideration in its prices to the

[7] Staff references Ex. S-4 as evidence that GCSC's affiliates add profit to the Company's telecom charges. Staff BR at 16. Staff is correct that Ex. S-4 reflects a profit, but as the Company has informed Staff, Ex. S-4 is in error. Ex. S-9 is actually correct, and as a result of the Company's mistake with respect to Ex. S-4, Staff's adjustment to remove affiliate profit is overstated by $3,793 for AWS and $1,677 for APS.

Company. It is not a pass-through. Nevertheless, Staff has tried to use "smoke and mirrors" to use the cost of postage to cast further doubt on the reasonableness of the Company's operating expenses.[8]

Staff's description of "layers of profit" is also misleading. *See, e.g.*, Staff BR at 5. Each affiliate, AWS, APS and APT provides different services and charges separately. Sorensen RJ (Ex. A-9) at 4-6. There is only one layer of profit—AWS or APS seeks to recover a profit on the services it provides. APT charges do not include a profit or mark-up. TR at 579 (Bourassa). Again, if the Commission disallows profit on affiliated transactions, none is recovered from ratepayers. TR at 406 (Sorensen). For this reason, Staff's claim that Algonquin's organizational structure "guarantees" affiliates' profits is also in error. Staff BR at 7.

Affiliate costs are variable, which means that there is no assurance that the affiliates will earn a profit in a given year. Sorensen RJ (Ex. A-9) at 4-6. This also answers Staff's question about "what financial incentive do employees of AWS have to minimize costs"? Staff BR at 16. This is basic business. The Company is also subject to basic regulation. Not one dime of profit or any other cost is "guaranteed" to a regulated utility, before or after rates are set. The best any utility can hope for is the opportunity to earn its authorized revenue, which will only include a profit on services provided by

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[8] Instead of using "Schedule A" and "Schedule C" as it did, Staff could have looked at the budget as presented. The AWS budget simply had the two revenue sources as spelled out in the Operating Agreement: Operating Fee (fixed) and Customer Service/ Accounting Fee (per bill). *See* Ex. S-9. Subtracted from these AWS revenue sources were AWS costs, including operator wages, benefits and related for each of the four direct operations personnel, wages, benefits and related for shared operations personnel, wages, benefits and related for administrative personnel (accounting, billing, customer service, etc.), postage, overhead, and taxes. *Id.* There was no amendment done because none was needed; Staff completely misunderstood or worse, misrepresented the agreement, budget, and supporting schedules.

affiliates if the Commission says so. There are no guaranteed profits anywhere in the regulated utility industry.

Sadly, against Staff's parade of horribles, the accomplishments of the Company, its shareholders and affiliates are easily overlooked. But this is the same Company that solved serious odor, noise and effluent problems. This is the same Company that has honored the obligation made in the 2001 rate case settlement agreement and improved operations. There is no problem with the Company's operations. The dispute in this case is limited to the inclusion of "affiliate profit" in rate base and operating expenses. The Company disagrees with Staff's adjustment to remove affiliate profit. Further adjustments to affiliated transactions are clearly unwarranted on the record in this rate case.

4. The Additional Relief Staff Seeks Should Not Be Granted

Staff also asks that the Commission pierce the corporate veil and require AWRA to continue to operate a shared services center. Staff BR at 23. There are several problems with Staff's request.

First, AWRA is neither a party to this proceeding, nor a public service corporation.[9] Any relief issued against AWRA would violate fundamental due process and exceed the Commission's authority. No current Commission rule applies to AWRA's day-to-day business operations nor requires that any particular business model be utilized. No such rule existed when AWRA acquired GCSC. Essentially, Staff is asking the Commission to modify the Commission's rules, presumably the affiliated interest rules, to prohibit certain types of business structure. Again, this type of legislation of public service corporations requires a rulemaking.

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[9] In fact, AWRA does not even provide affiliated services to GCSC, those services are provided by AWS, APT and APS. Sorensen RJ (Ex. A-9) at 2-3.

Second, no basis exists to pierce the corporate veil. Staff actually asserts that "the facts of this case are so extreme that the Company should have anticipated that the Commission would pierce the corporate veil." Staff BR at 19. The Company disagrees that these facts are extreme, given the lack of any evidence of harm and the amount of revenue at issue relative to the total revenue requirement. Moreover, as discussed above, there has never been a case like this in Arizona and the jurisprudence from other jurisdictions does not suggest a prohibition on affiliate transactions or profit; in fact, it may support the opposite as discussed above. There was no reason to anticipate piercing the corporate veil. And, more importantly, it would not be lawful to do so in this case.

Staff's arguments, allegedly in favor of piercing the corporate veil, are in reality merely a re-wording of its position to disallow affiliate profits. However, neither Staff's allegations nor Arizona law support piercing the corporate veil in this case. Arizona law strongly supports the treatment of corporations as separate entities. *See, e.g., Arizona Public Service Co. v. Arizona Corp. Comm'n*, 155 Ariz. 263, 267, 746 P.2d 4, 8 (App. 1987) (Declining to pierce the corporate veil because the Commission offered no evidence of undercapitalization, fraud, misconduct or impropriety in the management of the affiliated companies.); *Deutsche Credit Corp. v. Case Power & Equipment Co.*, 179 Ariz. 155, 160, 876 P.2d 1190, 1195 (App. 1994) ("The concept of a corporation as a separate entity is a legal fact, not a fiction."). The general rule is that "corporate status will not be lightly disregarded." *Keams v. Tempe Technical Institute, Inc.*, 993 F.Supp. 714, 723 (D.Ariz 1997); *and Dietal v. Day,* 16 Ariz. App. 206, 208, 492 P.2d 455, 457 (App. 1972).

Arizona law (as Staff recognizes) requires those seeking to pierce the corporate veil to show that "the financial setup of the corporation is a sham and causes an injustice," and accordingly, that Staff must prove "unity of control and that observance of the corporate form would sanction a fraud or promote injustice." Staff BR at 20 (emphasis added). Staff completely fails to meet these necessary prerequisites. Staff provides no evidence that the corporate entities herein are a "sham". There is absolutely no evidence that GCSC or any of the affiliated corporations herein were improperly incorporated, disregard corporate formalities, intermingle corporate assets and funds, or present themselves to the public in a fraudulent manner. *See, e.g., Chapman v. Field*, 124 Ariz. 100, 102-103, 602 P.2d 481, 483-484 (1979) (Even when shareholders lent money to corporation without taking promissory notes, failed to file annual reports with the Arizona Corporation Commission, and failed to keep proper books of account, court was correct in not piercing corporate veil because no evidence of sham). Rather, Staff's argument boils down to Staff's reliance on common ownership and common officers between GCSC and AWRA. Staff BR at 22. Evidence of common ownership and common officers alone, however, does not create a sham under Arizona law. *See, e.g., Deutsche Credit*, 179 Ariz. at 160-161, 876 P.2d at 1195-1196.

In *Deutsche Credit*, plaintiff, like Staff here, presented evidence of common officers and owners. *Deutsche Credit*, 179 Ariz. at 160-161, 876 P.2d at 1195-1196. The court noted that much more was required to support a finding of alter ego and the resulting piercing of the corporate veil. The Court stated:

> Additional proof [other than common ownership and officers] is required to show that the corporations were "alter egos" .... Arizona decisions have identified the following considerations, among others, as material to this issue: common officers or directors; payment of salaries and other expenses of subsidiary by parent (or of corporation by shareholders); failure to maintain formalities of separate corporate existence; similarity of corporate logos; plaintiff's lack of knowledge of separate corporate existence; owners' making of interest-free loans to corporation; maintaining of corporate financial records; commingling of personal and corporate funds; diversion of corporate property for shareholders' personal use; observance of formalities of corporate meetings; intermixing of shareholders' actions with those of corporation; and filing of corporate income tax returns and ACC annual reports.

Id. (citations omitted). Staff has not shown that the corporate entities herein are a sham.

Second, Staff provides no evidence that observing the corporate entities status herein would work a fraud or injustice. Rather, Staff argues that injustice is created herein solely by the fact that the entities are affiliated. Staff BR at 23. To make its argument of fraud and injustice, Staff asks the Commission to ignore the fact that ratepayers receive savings through the Algonquin business model. *Id.* The business model may be relatively new, and Staff may be struggling to deal with its operation, but saving ratepayers money is neither a fraud nor an injustice. The only evidence before the Commission is that the business model produces reasonable costs and charges. Obviously, such result is not a fraud or injustice and, in the final analysis, the Commission may choose to remove affiliate profit as a ratemaking adjustment. Under Arizona law, however, the Commission does not have any legal or factual basis to pierce the corporate veil here because the underlying record doesn't even remotely demonstrate a sham, fraud or injustice as required in order to disregard the separate status of corporate entities.

Nor can the Commission order the Company, AWRA, AWS or APIF to expend costs and forgo profit in order to achieve a predetermined operating model and expense level, in this case or otherwise. "It must never be forgotten that, while the State may regulate with a view to enforcing reasonable rates and charges, it is not the owner of the property of public utility companies, and is not clothed with the general power of management incident to ownership." *Southern Pacific Co. v. Arizona Corporation Commission*, 98 Ariz. 339, 342, 404 P.2d 692, 694 (1965), citing *State of Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Commission of Missouri*, 262 U.S. 276 (1923).

Arizona law is clear that it "is not the purpose of regulatory bodies to manage the affairs of a corporation." *Southern Pacific Co.,* 98 Ariz. at 343, 404 P.2d at 696.

"Nowhere in the Constitution or in the statutes is the Commission given jurisdiction, directly or by implication, to control the internal affairs of corporations. . ." *Arizona Corporation Comm'n v. Consolidated Stage Co.*, 63 Ariz. 257, 260, 161 P.2d 110, 113 (1945). "The day-to-day operation and running of public service corporations are matters of management prerogative, and are beyond the power of the Commission to control—at least directly." Attorney General Opinion I79-099 (April 9, 1979). "The Commission has the power to supervise and regulate public utilities as it finds them. It has nothing to do with creating or bringing them into existence." *Williams v. Pipe Trades Industry Program of Arizona*, 100 Ariz. 14, 18, 409 P.2d 720, 723 (1966).

Ultimately, Staff advocates a policy that will almost certainly require utilities like GCSC to use a traditional regulatory model. In doing so, Staff ignores the widespread failure of traditional regulation to deal with economic change in the 1980s and 1990s. The policies urged by Staff in its closing brief violate fundamental principles of due process and exceed the Commission's constitutional and statutory authority under Arizona law. Further, Staff recommends bad policy. Instead of approving a rigid policy of excluding affiliate profit, the Commission should endeavor to strike a balance between preventing discriminatory conduct by utilities and their affiliates, and preserving and incenting the use of possible economies of vertical integration. At a minimum, the Commission should approve possible methods to establish the competitive nature of affiliate transactions (such as competitive bidding), including affiliate profit. The principal goal of the Commission should be to encourage market mechanisms (such as affiliate transactions) to reduce utility costs while preventing excessive or unjustified costs resulting from affiliate transactions. If the Commission approves Staff's recommendations to adopt a *de facto* policy excluding affiliate profit, then the Commission will discourage market efficiency in the provision of utility services. In turn, utility costs and customer charges will increase as a consequence of such *de facto* policy.

5. Central Overhead Allocations

Staff and the Company now appear to be in agreement that the issue over these charges, $4,000 per month, is one regarding the sufficiency of the evidence. Compare Staff BR at 23 ("Staff's argument based on lack of supporting documentation") *with* Company BR at 16 (alleging that Staff wanted different evidence). But, as Staff keeps pointing out, this is the exact same business model as AWRA uses to operate BMSC, and Staff was given the exact same supporting evidence in this case as it was provided in BMSC. TR at 1136 (Brown). The only difference is in the amount—because GCSC is larger than BMSC, its allocation is higher. Ex. S-4 at 8. In other words, under the Algonquin shared services model, the cost of services are shared on a *pro rata* basis, allowing the economies of scale achieved to lead to broader services. The same costs were found reasonable in the recent BMSC rate case and they should be again in this rate case.

B. Issues Remaining In Dispute With RUCO[10]

1. RUCO's Position On Excess Capacity Is Without Merit

RUCO argues that peak wastewater flows "are not a relevant measure of needed capacity." RUCO BR at 4. This statement is incredible and would actually be amusing if this kind of thinking did not underlie RUCO's recommendation to remove $2.8 million of

[10] In addition to the issues addressed in this reply, RUCO also asserts that the Commission should adopt its depreciation expense and its rate design. The Company believes that RUCO depreciation and expense are simply consistent with its other recommendations, which should be rejected for the reasons set forth in the Company's closing briefs. However, because RUCO failed to file Final Schedules, GCSC is unable to verify this to be the case.

prudently built utility property from the Company's rate base. RUCO has fallen far short of showing that its recommended adjustment is fair and appropriate.

To begin with, RUCO is hopelessly confused over how to determine sufficient capacity. Its claim that peak flows are irrelevant contradicts the testimony of its own witness:

> Q. It is appropriate for a utility to consider its peak flows in deciding how much capacity it needs to serve its customers.
>
> A. Yes. It has to consider its peak flows.

TR at 951-52 (Moore). And it is a good thing for ratepayers that GCSC agreed with Mr. Moore and not with RUCO and concluded that peak flows are relevant. As Mr. Moore further recognized

> Q. And you would agree with me that if a utility does not have sufficient capacity to treat peak flows, that can threaten the public health, couldn't it?
>
> A. Correct.
>
> Q. And you would agree with me that spills and illegal discharges are something that sewer utilities should avoid.
>
> A. Yes. And we commend the Company for eliminating those problems.

Id. at 953-54.

RUCO's recommendation also contradicts the competent engineering and operator testimony in this case regarding sufficient capacity. *Compare* RUCO BR at 2 *with* Company BR at 11-12 *citing* TR at 1039-41 (Scott) and Hernandez RB (Ex. A-6) at 5. RUCO claims that "excess capacity is capacity over and above what is necessary to provide service to the existing customer base." *Compare* RUCO BR at 2 *with* Company BR at 11-12 *citing* TR at 1039-41 (Scott) and Hernandez RB (Ex. A-6) at 5. Mr. Scott testified that excess capacity means capacity greater than the amount needed over a five-year planning period. Both Mr. Scott and Mr. Hernandez testified to an industry standard that requires new capacity planning to commence when 80% of capacity is reached. *Id.* However, according to RUCO's "regulatory accounting standpoint" (RUCO BR at 2), a 100% rule is followed whereby the utility should start planning and building capacity only when its current customer base is using every gallon of available capacity. It is highly doubtful that regulatory agencies would agree with RUCO's "regulatory accounting standpoint" under which cost recovery principles drive the determination of when to build new capacity rather than the health, safety and comfort of ratepayers. *See* TR at 133-34 (Hare); 1039-41 (Scott). RUCO's proposed method would also greatly increase the cost of capacity for utilities as smaller, incremental capacity is more expensive than rational incremental capacity. *E.g.* TR at 952-58 (Moore); Hernandez RB (Ex. A-6) at 6.

As asserted in the Company's closing brief, RUCO's issues actually stem from its overly narrow "regulatory accounting standpoint". RUCO lacks competent engineering and operations expertise. TR at 945-46 (Moore). How else can one explain RUCO's comparison of electricity storage with wastewater storage? RUCO BR at 4, n. 2. According to RUCO, sewer utilities like GCSC do not need permanent capacity to meet peak flows because they have storage, also known as equalization basins, that allow excess wastewater flows to be stored for future treatment. RUCO BR at 4 *citing* TR at 271-72 (Hernandez). This is quite a leap from the testimony RUCO cites. At hearing, RUCO's counsel asked Mr. Hernandez

> Q. And isn't the purpose of an equalization basin to accommodate fluctuations in flows?
>
> A. Yes, sir.
>
> Q. So during peak hours the excess over the normal flow is stored in the basins, and the flow is equalized?.
>
> A. It can only store so much, sir. If the flow is coming in so fast, its time is lowered by how fast the flow is coming in. **It could be 15 minutes to an hour.**

> Q. But in a situation where you do have peak hours, wouldn't the excess be stored in the basins and the flow equalized?
>
> A. Not really, sir. It's not big enough to actually store a lot of flow inside it. It's more of the equalization basis. So when the flow comes in, we have a chance to spread it out between the two plants.

TR at 271-72 (emphasis added). Either RUCO lacks any understanding of sewer utility operations or it lacks respect for the Commission, the parties and the process. There is no other explanation for RUCO's contention that Mr. Hernandez' testimony shows that sewer utilities do not need capacity to treat peak flows because they have storage.

RUCO continues to explain that it does not take issue with the fact the Company acted prudently and saved ratepayers money, or whether GCSC has a right to recover. RUCO BR at 3. RUCO just disagrees with when recovery should begin. Again, RUCO either does not understand or ignores the evidence. For starters, RUCO argues that the Company unquestionably had excess capacity during the test year. RUCO BR at 3. This is obviously an overstatement—since the new capacity came on line at the same time the test year ended, the Company's test year peak flows were 117% of the then available capacity of 1 MGD. Next, RUCO argues that GCSC "presently" has excess capacity. *Id.* The Company does not presently have excess capacity. The test year peak would have been equal to almost 80% of the 1.5 MGD capacity RUCO suggests as the upper limit of used and useful. Further, the Company is expected to reach 80% of available capacity in the next few months, and is expected to reach its maximum capacity within five years. Scott DT (Ex. S-10), Exhibit MSJ at 4. The Company presently has 1.9 MGD of used and useful treatment capacity. *See* Staff BR at 30.

Finally, RUCO's excess capacity adjustment is anything but "fair and reasonable." RUCO BR at 5. Without offering engineering or operations witnesses, RUCO seeks to confiscate almost $3 million of utility property because GCSC "prudently" spent under

$1 million to complete its facility as part of the Plant renovation project completed in October 2005, rather than after another round of disruptive construction at a much higher cost. TR at 303-04 (Hernandez); 963 (Moore). Adoption of RUCO's recommendation would send the message that utilities should avoid making prudent financial decisions that minimize interruption to the community and protect the public health and safety because regulatory accountants disagree with prudent engineering decision making. There is simply no basis for such a decision.

2. RUCO's Position On Property Taxes—Nothing New Here

RUCO's brief on the issue of property tax expense offers little more than recycled arguments that have repeatedly been rejected by the Commission. Yet, RUCO makes no effort to distinguish this case from the wealth of Commission precedent explicitly rejecting RUCO's assertions.

RUCO again states that it is the only party using the ADOR formula. RUCO BR at 10. RUCO then goes a step further and suggests that prior Commission decisions claim that ADOR is unreasonably understating property taxes. *Id.* at 12. Frankly, RUCO's arguments are ludicrous. All parties and the Commission's many orders utilize the ADOR formula, the dispute is over the revenue inputs. RUCO is the only party that refuses to consider revenue increases in the determination of a level of property tax expense for **ratemaking** purposes. Perhaps RUCO's problem is that it views itself as actually being involved in determining the level of this expense for **valuation** purposes. *Id.* at 10. The Commission is calculating expenses for ratemaking, not valuation and assessment, a job left to ADOR. Decision No. 69164 at 10-11 *citing* several prior Commission decisions.

RUCO's claimed "evidentiary" support is equally hollow. In this case, as it has also done several times before, RUCO argues that the evidence shows that the ADOR formula is more accurate than the Commission's determination of property taxes. RUCO

BR at 10. The Commission is setting rates to be charged in the future. RUCO is calculating property taxes that have already been assessed. ADOR will never again use the inputs RUCO utilizes to calculate a level of property taxes and rate increases will have a substantial impact on the Company's property tax expenses. RUCO totally ignores this fact, which is why the Commission has repeatedly told RUCO that its recommended methodology is "unfair and unreasonable". *Id.* The Commission will just have to do so again in this case.

3. RUCO's Recommended Rate Case Expense Is Unreasonable

RUCO's position on rate case expense should also be rejected. RUCO's argument that the lack of complexity in this case justifies rate case expense of $70,000 is mind-boggling. RUCO BR at 6-7. This case has taken far longer than anyone imagined. There have been more filings, more witnesses and more hearing days than anticipated. Customers and Commissioners were actively involved. The issues surrounding odors, Mr. Hill's comments to ratepayers, and affiliates transactions were divisive and time consuming, not to mention RUCO's efforts to confiscate rate base and reduce the revenue requirement by more than $500,000. Kudos to RUCO if it does not view any of this as complex, but there can be no legitimate claim that these issues have not been controversial and that they have led to substantial rate case expense.

RUCO seeks to bolster its punitive level of rate case expense with a number of arguments, none of which can withstand basic scrutiny. For instance, RUCO claims, without citation, that the Company's copying costs were unreasonable "given the facts and circumstances of this case." RUCO BR at 9. What "facts" and what "circumstances"? The copying costs were incurred to meet the demands of discovery and requirements of the Commission. The costs RUCO claims are unreasonable were roughly $2,000 less than were incurred in the recent BMSC rate case. TR at 597-98 (Bourassa). No adjustment was made to rate case expense in the BMSC rate case, despite

RUCO's challenge. *See* Decision No. 69164 at 11-12.[11]

RUCO's accusations about the Company's failure to cooperate on minimizing rate case expense are also easily refuted. On June 21, 2006, counsel for RUCO wrote to undersigned counsel asking if RUCO could modify its instructions for data request responses in order to reduce copying costs. Moore SB (Ex. R-10) at Exhibit C. RUCO continues to ignore the fact that this was after RUCO and Staff (except Ms. Brown's direct) had filed direct testimony and the vast majority of the discovery was complete. Moreover, RUCO's allegation of non-cooperation is utterly false. RUCO BR at 7 (the Company "would not cooperate with RUCO in its attempts to mitigate rate case expense such as copying costs."). RUCO's own witness submitted the Company's immediate response to RUCO's request. Moore SB (Ex. R-10) at Exhibit C. That response made two points: one, that the Company would not be placed in a position of making substantive decisions on what copies RUCO wanted and did not want in response to discovery requests; and two, that the Company would work with RUCO by making all data request responses available to RUCO so that it could decide for itself what it wanted. *Id.*

RUCO ignored the Company's concerns as well as its offer of alternative cooperation. Frankly, it appears that RUCO was merely attempting to set up a basis to challenge rate case expense. But, RUCO has presented no evidence reflecting the impact of the alleged failure to cooperate on rate case expense, nor did RUCO rebut the Company's assertion that RUCO's alleged mitigation effort was too late to have any impact in this case.

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[11] During the hearing, counsel for RUCO challenged the comparison to the copying costs in the BMSC rate case because no decision had been issued at that time. TR at 600-01 (Bourassa). Obviously, such concerns are no longer of consequence if they ever were in the first place.

Finally, RUCO's redaction arguments are not persuasive. The Company is not attempting to place its right to attorney-client privilege ahead of the Commission's "need to know" nor is GCSC turning this into a legal issue. RUCO BR at 7.[12] Actually, it is RUCO that is making this a legal issue by asserting that the Company must waive the attorney-client privilege in order to recover rate case expense. RUCO offers no supporting authority for this position whatsoever, not one case from this Commission or another jurisdiction is cited. Moreover, this Commission has more than substantial evidence before it upon which to make a determination of reasonable rate case expense, including the partially redacted legal invoices. If RUCO felt otherwise, it had many available remedies, yet it pursued none of them. The Commission, meanwhile, has never directed the Company to waive the attorney-client privilege and the entire issue seems to have done nothing more than increase the amount of rate case expense the Company will incur, increases it will absorb without any impact on ratepayers.

In summary, perhaps RUCO is right, $160,000 is not an appropriate level of rate case expense—it should be much higher. But the Company has agreed to limit its request to $160,000 and, under the facts and circumstances of this case, that is clearly reasonable. *Compare, e.g.,* Decision No. 69164 at 12 (awarding rate case expense of $150,000 to BMSC.[13]

C. Capital Structure And Cost Of Capital

Staff asserts that its financial models are "widely accepted in the financial industry and by most state commissions in setting just and reasonable rates." Staff BR at 32.

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[12] The Commission never directed GCSC to submit unredacted invoices in this case because it had a "need to know", nor is the Company or its counsel aware of any such order ever being issued by the Commission.

[13] RUCO's remaining assertions regarding rate case expense are already addressed in the Company's closing brief and need not be repeated herein. *See* Company BR at 18-21.

Staff offers no citation for this bold assertion and no witness provided testimony on the ROR methodologies utilized or the returns actually authorized in other jurisdictions. It is certainly doubtful that Staff could find another jurisdiction where the regulatory agency simply adopts its Staff's recommended cost of capital in virtually every single rate case. Nor does Staff appear to be right.

In California, regulators have recognized that there is no market data available for smaller utilities and, therefore, the analysis using financial models cannot be applied. Memorandum, Director Water Division, California Public Utilities Commission (2004), copy attached hereto as Reply Brief Exhibit 1. Additionally, the California PUC recognizes that smaller utilities have higher business and operational risks that require higher returns. *Id.* It is also recognized that higher returns are required to encourage investment for small utilities. Finally, it bears noting that in 2003 the California PUC was authorizing nearly 10% returns for large water utilities when interest rates were much lower, while Staff was recommending and the Commission was accepting 9.2% back in 2003. *Compare id. with* Bourassa RB (Ex. A-11) at 35.

But, perhaps even more importantly, Staff's claim that its models are used in other jurisdictions misses the point. It is not the models themselves, it is Staff's rote application of the models followed by the Commission's mechanical acceptance of the results and rejection of all other evidence that is the problem. As discussed in the Company's closing brief, Staff chooses inputs that hold down ROEs, notwithstanding changing economic factors. TR at 1083-98 (Irvine). Then, to make matters worse, Staff blindly accepts the results (unless a downward adjustment is needed to make the utility look more like Staff's sample companies). This undermines the benefits of using the financial models to determine a cost of capital.

As Roger Morin writes in his authoritative text

> The court cases discussed previously indicated that there are no specific rules or infallible models for determining a fair rate of return. It is dangerous and inappropriate to rely on only one methodology in determining the cost of equity. The results from only one method are likely to contain a high degree of measurement error. The regulator's hands should not be bound to one methodology of estimating equity cost, nor should the regulator ignore relevant evidence and back itself into a corner. For instance, by relying solely on the DCF model at a time when the fundamental assumptions underlying the DCF model are tenuous, a regulatory body greatly limits its flexibility and increases the risk of authorizing unreasonable rates of return. The same is true for any one specific model.
>
> * * *
>
> There are four generic methodologies available to measure the cost of equity: DCF, Risk Premium, and CAPM, which are market-oriented, and Comparable Earnings, which is accounting-oriented. Each generic market-based methodology in turn contains several variants.
>
> * * *
>
> When measuring equity costs, which essentially deals with the measurement of investor expectations, no one single methodology provides a foolproof panacea. Each methodology requires the exercise of considerable judgment on the reasonableness of the assumptions underlying the methodology and on the reasonableness of the proxies used to validate the theory. It follows that more than one methodology should be employed in arriving at a judgment on the cost of equity and that these methodologies should be applied across a series of comparable risk companies.

Roger A. Morin, *New Regulatory Finance* (2006) at 28. Over the past few years Staff has used the same models with the same inputs and Staff's ROEs have remained remarkably immune to changing economic conditions. Bourassa RB (Ex. A-11) at 35. The Commission repeatedly accepts Staff's recommendation. While Staff does employ the use of 2 models, this is hardly what Dr. Morin had in mind. Staff doesn't apply any sort of economic reality check to the results its models initially produce. As noted in

GCSC's closing brief, interest rates have increased substantially for the past three years, while Staff's recommended ROEs remain largely unchanged. *Id.* In fact, Staff's recommended ROE is less than 100 basis points above current prime rates.

Of course, Staff argues that it is the Company's results that are skewed and that the Company's witness used non-market data. Staff BR at 33-35. To begin with, if both parties are skewing the results, in this case in different directions, the solution should not be the repeated acceptance of one extreme over the other. Moreover, Staff's claim that the Company's witness is using non-market data is wrong. Mr. Bourassa's methods use both market interest rates and actual and authorized earnings. Bourassa RB (Ex. A-11) at 37-38. The inputs to the DCF are accounting based inputs e.g., earnings per share and dividends per share. Staff cannot seriously be suggesting that actual and authorized returns are not just as relevant to investors as market data.

In fact, one thing Staff and the Company appear to agree on is that reasonable investor expectations are important to the process of determining the cost of capital. *See* Staff BR at 32. But there is much disagreement between the parties over what constitutes reasonable investor expectations. The Company asserts that investors certainly consider actual and authorized returns. Bourassa RB (Ex. A-11) at 37-38. Similarly, the Company does not agree with Staff or RUCO that investors will see an investment in Aqua America or American States as more risky than an investment in GCSC because those utility holding companies have more debt in their capital structure. *See, e.g.*, Staff BR at 33; RUCO BR at 14. Such reasoning stands economic reality on its head. And, so do the results of Staff's financial models, which have been shown to be designed and applied to ensure that ROEs remain artificially low.[14]

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[14] GCSC addressed RUCO's capital structure and cost of capital arguments in its closing brief and RUCO offers nothing new in its brief. Moreover, RUCO's analysis is flawed, largely for the same reasons as Staff's.

D. The Company No Longer Has An Odor Problem

Staff states that GCSC "has adequately responded to the odor complaints of the public and has instituted the proper measures." Staff BR at 27. The Company appreciates Staff's positive discussion of its successful efforts to control odors from the Plant, but wonders whether Staff recognizes that such success comes from the same business model it so callously discards in discussing affiliate profit. In any event, no party has filed a brief challenging the Company's position that the "odor" issue has been resolved and should have no impact on the rates. And it shouldn't. This is a success story and the question Commissioner Mayes posed in her August 9, 2006 letter has been answered in this rate case—Algonquin's ownership has clearly "improved operations, especially related to odor control."

E. The Prior Statements By Mr. Hill In 2002 Should Not Have Any Bearing On This Rate Case

Commissioner Mayes' other question also has been answered, notwithstanding the Company's objections to the question in the first place. The Company did not promise its ratepayers that it would never raise rates for any of the recent Plant renovation expenses, including odor control. *E.g.,* TR at 689-90, 722-25 (Hill). Again, no party filed a brief asserting otherwise and the only remedy being sought on the issue is Staff's recommendation that the Commission gag the Company. Staff BR at 32. Staff's suggested remedy is unnecessary and unworkable, not to mention a violation of the Company's rights to commercial free speech.

To begin with, all of the statements at issue were made by the former President, who left the Company in 2003. Hill PT (Ex. ACC-2) at 1-2. The evidence demonstrates that the statements at issue were not made in bad-faith, they were just poorly-worded. TR at 679 (Hill). There is also no evidence that any other Company representative has ever made such statements. The bottom line is that Mr. Hill's prior comments did not harm customers in any way and, as a result, the Commission does not have a legitimate reason to proscribe the Company's communications with its customers.

Moreover, requiring the Company to obtain Commission approval before making certain types of statements will require the Company to avoid providing needed information to its customers and result in unnecessary regulatory proceedings that delay the provision of needed information to ratepayers. Staff's recommendation is impractical and unworkable. The net result would be that the Commission would become responsible for communications between GCSC and its customers. As a consequence, Staff's suggested relief should not be granted.

RESPECTFULLY SUBMITTED this 2nd day of February, 2007.

FENNEMORE CRAIG, P.C.

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By: Maria San Jose

Reply Brief

Exhibit 1

State of California

Memorandum

Date: May 21, 2004

To: Izetta C. R. Jackson, Director – Water Division

From: **Public Utilities Commission—**
San Francisco –
Seaneen M. Wilson, FEIV

Subject: *Concerns regarding how Rates of Return and Returns on Equity are determined for Class A, B, C, and D Water Utilities*

Overview

I would like to address two issues in this memorandum – 1) Concerns regarding the determination of a Rate of Return (ROR) for Del Oro Water Company, and 2) Explanation of the specific methods used to determine the ROR for the various classes of water utilities.

Concerns Regarding Del Oro ROR

Prior to the May 6th Commission meeting, an advisor raised concerns regarding the determination of the Rate of Return (ROR) of 8.53% for Del Oro Water Company (Del Oro) (Agenda Item 16 at May 6th Commission Meeting). There was a concern that the ROR for this Class B water utility was 100 basis points lower than ROR's recently authorized for Class A water utilities.

First of all, the recommended ROR for Del Oro is not 100 basis points less than the ROR's most recently authorized for Class A water utilities. In particular, at the May 6th meeting, California-American Water was authorized a ROR of 6.74% (D.04-05-023) and the next most recent authorized ROR is 8.79% for Southern California Water (D.04-03-039). Not only are these returns not 100 basis points greater than that recommended for Del Oro, in the case of California-American, its ROR is 179 basis points lower than that recommended for Del Oro.

Second, as described below, there is a particular method for determining the ROR for each Class of water utility. If the suggested adjustment of a 100 basis point increase is made to the ROR, the Return on Equity (ROE) for this Class B water utility would be greater than that authorized for a Class D water utility, which is not appropriate. (see detailed discussion below)

Methods for determining ROR for Different Classes of Water Utilities

One of the duties of this Commission is to authorize the ROR and ROE for Class A, B, C, and D water utilities. Given the different characteristics of and risks faced by each class of water utility, the ROR and ROE are calculated differently for each.

Class A – 10,000 or more customers

The ROR for Class A water utilities is determined by summing the weighted cost of each component of the capital structure (cost factor times percentage of capital structure). This capital structure is normally made up of long-term debt and common equity. The long-term debt cost is based on the rates each company pays its lenders and the ROE is determined by the Commission after assessing the results of market based models run on a comparable group of water utilities. (Example attached at p. 4 – Table 1-1)

Class B – 2,000 – 9,999 customers

The ROR for Class B water utilities is determined in a similar fashion, except for the calculation of the ROE. Since market data is not available for water utilities comparable to Class B (companies of this size are not publicly traded), staff averages the most recently authorized Class A and Class C ROE's in order to determine the appropriate ROE for a Class B company (see attached tables at p.5 – Class B Tables). The company specific capital structure and cost of long-term debt[1] are then combined with this Class A & C average ROE to determine the overall ROR for the Class B water utility.

Del Oro ROR

As the first Class B Table shows (page 5), the ROR calculated for Del Oro is 8.53%. This is based on a combination of the company specific capital structure and cost of long-term debt and the average of the recently authorized Class A and C returns. A suggestion has been made that this company receive a ROR of 9.50%. If this ROR is plugged into that calculation, the resulting ROE would be 13.57%, which is greater than the highest ROE currently being recommended for Class D water utilities of 13.4% (page 6).

Class C & D – C = 500- 1,999 customers / D = 1 – 499 customers

The ROR for Class C and D water utilities is determined based on procedures adopted in

1 D.92-03-093, p. 30, "As to rate of return, we will continue to deal with Class B utilities on a case by case basis."

D.92-03-093.[2] Since most Class C and D water utilities do not have any long-term debt, (or, if they do it is covered by a principal and interest surcharge and not included in rates) their total capital structure consists of common equity. The ROE that is determined for Class C and D water utilities is also the ROR. Per D.92-03-093, each year the Water Division reviews the movement of interest rates in the past year as well as ROEs authorized for Class A water utilities to determine the appropriate ROEs for the Class C and D water utilities. (See attached March 1, 2004 memo) If there is material movement up or down in interest rates or the authorized Class A ROE's, then the range of ROEs recommended for Class C and D water utilities is adjusted in the same direction. A range of ROE's is provided so that the analyst can consider the specific risks faced by each individual company in a particular class.[3]

If you have any questions or would like to learn more about cost of capital for water utilities, please contact me at 415-703-1818 or smw@cpuc.ca.gov.

2 D.92-03-093, p. 29, "Because we recognize that Class C and Class D water utilities are fundamentally different from Class A water utilities in terms of the operational and financial risks they face, it is not appropriate to tie the range of returns to those of Class A utilities. Instead, we will have CACD prepare an annual recommendation to the Commission on the appropriate range of returns fro Class C and D utilities. Consideration will be given to changes in financial conditions and substantial changes in operational conditions meriting adjustment to the range of reasonable returns."
3 D.92-03-093, p. 29, "Use of a range allows for acknowledgement of differences in water quality, service, and management.".

Table 1-1

	Capital Structure	Cost Factor	Weighted Cost
Test Year 2003			
Long-Term Debt	55.92%	7.39%	4.13%
Common Equity	44.08%	9.54%	4.20%
Total	100.00%		8.34%
Test Year 2004			
Long-Term Debt	57.56%	7.28%	4.19%
Common Equity	42.44%	9.54%	4.05%
Total	100.00%		8.24%
Test Year 2005			
Long-Term Debt	58.35%	7.16%	4.18%
Common Equity	41.65%	9.54%	3.97%
Total	100.00%		8.15%
Test Year 2006			
Long-Term Debt	58.40%	7.46%	4.36%
Common Equity	41.60%	9.54%	3.97%
Total	100.00%		8.32%

Class B Tables

Del Oro Group of Companies
Cost of Capital

Description	Capital Ratios	Cost Factors	Weighted Cost Factors
Long Term Debt	67.20%	7.57%	5.0
Common Equity	32.80%	10.98%	3.6
Rate of Return	100%		8.6

Del Oro Group of Companies
Class B Water ROE

Description	ROE
Most Recently Authorized Class A ROE	9.80%
Average of Range of Class C ROE's recommended by Water Division	12.15%
Average	**10.98%**